*United States Court of Appeals*

*for the Second Circuit*

# APPELLEE'S SUPPLEMENTAL BRIEF

# 75-7203

## United States Court of Appeals
FOR THE SECOND CIRCUIT

Robert Abrahamson and Marjorie Abrahamson,
*Plaintiffs-Appellants,*

*v.*

Malcolm K. Fleschner, William J. Becker, Harold [illegible] Ehrlich, Leon Pomerance, Fleschner Becker Associate[illegible] and Harry Goodkin & Company,
*Defendants-Appellees.*



P/S

ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

## SUPPLEMENTAL BRIEF FOR APPELLEE

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ROBERT ABRAHAMSON and MARJORIE ABRAHAMSON,

Plaintiffs-Appellants,

-against-

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, LEON POMERANCE, FLESCHNER BECKER ASSOCIATES and HARRY GOODKIN & COMPANY,

Defendants-Appellees.

Docket No. 75-7203

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SUPPLEMENTAL BRIEF FOR APPELLEE
HARRY GOODKIN & COMPANY

PRELIMINARY STATEMENT

Pursuant to the Court's request in its per curiam opinion, dated November 21, 1975, appellee Harry Goodkin & Company submits this supplemental brief on the issues raised under the Investment Advisers Act.

## ARGUMENT

I

### A PRIVATE DAMAGE ACTION MAY NOT BE IMPLIED FROM THE ENFORCEMENT SCHEME OF THE INVESTMENT ADVISERS ACT

Under principles expressed in the last three years by the Supreme Court and this Circuit, a private right of action for damages for the violation of a statute may not be judicially implied when the evident intent of Congress is to withhold such a remedy in the enforcement scheme of the statute.[1] A private damage action may not be implied for a violation of the Investment Advisers Act.

The Investment Advisers Act, as originally enacted in 1940, was relative to other securities legislation, a limited regulatory scheme and provided only limited means for the enforcement of the Act's substantive provisions. Subsequent amendments to the Act broadened its regulatory scope but, nevertheless, retained significant restrictions upon and withheld means for the enforcement of the Act's prohibitions. The Act's provisions and its development show that Congress intended a limited and sharply focused enforcement approach.

The impetus for the original legislation of 1940 was the Securities and Exchange Commission ("SEC") which had conducted pursuant to its authority under the Public Utility Holding Company Act of 1935 a study of the functions and

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1 Blue Chip Stamps v. Manor Drug Stores, --- U.S.---, slip. op. at B 2681, 2683 (1975); National Railroad Passenger Corp. v. National Association of Railroad Passengers, 414 U.S. 453 (1974); Chris Craft Industries Inc. v. Bangor Punta Corp., 480 F.2d 341 (2d Cir. 1973).

activities of investment trusts and investment companies.[2] The authority granted by the Public Utility Holding Company Act, however, was essentially limited to investment companies and investment trusts, and the SEC did not conduct an extensive study of investment advisers; its study of investment advisers was limited to investment advisers who were associated with investment companies.[3]

Since the SEC had not fully studied the investment advisory field in connection with its investment company study, the Commission did not propose comprehensive regulatory legislation of investment advisers to Congress. Rather, the Commission proposed enabling legislation for the conduct of a compulsory census of investment advisers which was the fundamental purpose of the Investment Advisers Act when initially enacted in 1940. David Schenker, representing the SEC testified in Senate Hearings:

> "Therefore, our fundamental approach to this problem is in the first instance, before we could intelligently make an appraisal of the economic function or of the abuses which might exist in that type of organization, to see if we could not get something which approximated a compulsory census. Fundamentally that is the basic approach of title 2. We first would like to find out how many people are engaged in this business, what their connections are, what is the extent

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2 See Investment Trust and Investment Companies Report of the Securities and Exchange Commission, pursuant to Section 30 of the Public Utility Holding Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services, H.R. Doc. No. 477, 76th Congress 2d.

3 See Hearings on S.3580 before Subcommittee of the Senate Committee on Banking and Currency 76th Congress 3d Session (hereinafter cited as Senate Hearings) at 51.

of their authority, what is their background, who they are, and how they handle the people's funds?[4]

Thus, the enabling of a compulsory census was a fundamental purpose of the proposed legislation. Other provisions, including the antifraud provisions were clearly of secondary importance. Mr. Schenker testified:

> "Aside from that fundamental approach, the only other provisions in that title are just a few broad general provisions which say that you cannot embezzle your client's funds or you cannot be guilty of fraud. One other provision relates to the transfer of the contracts which a client makes with investment counsel. I will elaborate on those provisions at a subsequent date."[5]

In adopting a fundamental approach of seeking a compulsory census, the Commission, of course, was likely not exalting the methodology of obtaining information to curb abuses over the abuses themselves. The methodology must have been perceived as a means to an end.[6] Yet, it

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4 Senate Hearings at 49.

5 Ibid.; see Senate Hearings at 327 for what appears to be the further evaluation.

6 The original bill contained a declaration of policy which included in a subparagraph (4) an expression of concern regarding fraudulent practices. This expression was deleted from the enacted bill. See, Securities and Exchange Commission v. Capitol Gains Research, Inc., 375 U.S. 180 (1963).

also seems that the very need for a compulsory census prevented Congress from legislating comprehensive regulation. Lacking the results of a full study of the field, Congress did not, except in the most general way, legislate against abuses in the field.

Similarly, Congress did not enact extensive enforcement provisions. Unlike prior securities legislation, the Act did not provide expressly for a private right of action. Furthermore, restrictions were placed on the enforcement powers of the SEC. Section 210 (b) restricted the SEC from making public disclosure of registration and investigatory matter. Section 210 (c) restricted the SEC in requesting disclosure by investment advisers who render supervisory services of the identity, investments or affairs of any client. Mr. Schenker testified:

> "The only other provision of consequence is section 210, which in our opinion would have a very salutary effect. The investment counsels were a little concerned about the effect on their business if it got around that the Securities and Exchange Commission was conducting an investigation. In order to safeguard against this danger section 210 (a) and (b) provide that there shall not be any disclosure of any investigation by the Securities and Exchange Commission until it has made up its mind that a public hearing is to be held. Then in order to safeguard them further, subsection (c), provides that the Commission cannot ask these investment counsellors to disclose their clients, and what their investments, are except that if there is some indication of wrongdoing. Thereafter, in connection with the investigation, they have to make disclosures."[7]

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7 Hearings on H.R. 10065 before Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Congress 3d Session (hereinafter cited as House Hearings) at 138; see also Senate Hearings at 713, 715.

Clearly, Congress, lacking complete information regarding the activities of investment advisers, tempered the enforcement provisions of the Act recognizing that unrestrained enforcement might be deleterious to the practice of investment advising.

Congress' failure to provide for any private action in the Act is logically related to Congress' restriction of the enforcement powers of the Commission. In a private action, the private plaintiff would not be subject to the restrictions imposed upon the Commission. A private right of action would, therefore, constitute a license to the private plaintiff to obtain or make disclosure of matters which a governmental agency acting with a concern for the public interest cannot do under the Act.

It cannot be accidental, then, that every piece of prior securities legislation, including the Investment Company Act,[8] which was title I of the legislation containing the Act, provided expressly in some respect for a private right of action when the Act does not in any respect. Likewise, it also is not an accident that Congress restricted enforcement of the Act by omitting from its jurisdictional grant to the courts in Section 214 jurisdiction over "actions at law brought to enforce any liability or duty" created by the statute; jurisdiction which is granted in all prior securities legis-

8 See Section 30 (f)

lation. A cautious Congress, lacking complete information regarding investment advisers and cognizant of the potential dangers of unrestricted enforcement of the Act, intended to restrict the means for the Act's enforcement by not authorizing, explicitly or implicitly, private damage actions.

The Investment Advisers Act was amended by the 86th Congress in 1960. This Congress recognized the limited purposes underlying the original legislation. The Senate Report states:

> "Of the five acts administered by the Securities and Exchange Commission, the committee is of the opinion that confronted by the problems it must solve, the Investment Advisers Act of 1940 is the most inadequate. The Investment Advisers Act of 1940 was passed as title II of the bill, of which title I was the Investment Company Act. Unlike other federal securities statutes, it has few substantive or regulatory provisions. Modeled somewhat on the broker-dealer registration provisions of the Securities and Exchange Act of 1934, it resembles a continuing census of the Nation's investment advisers."[9]

The 1960 amendments enlarged the SEC's enforcement powers and broadened other provisions relating to the enforcement of the Act. For example, Section 209 (e) was amended to authorize the Commission to bring injunctive

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9 S. Rep. No. 1760, 86th Congress, U.S. Code and Congressional Administrative News at 3503 (hereinafter cited as 1960 S. Rep. with page reference to U.S. Code & Congressional Administrative News).

actions against aiders and abettors;[10] section 210 (b) was amended to permit disclosure of investigatory information upon the approval of the Commission;[11] section 222 was added to express the concurrent jurisdiction of state regulatory authorities.

The 1960 amendments, however, retained the basic restrictions of the Act's enforcement contained in the 1940 legislation. The restrictions of section 210 preventing free disclosure by the SEC of investigatory matters and compulsory disclosure to the SEC by investment advisers rendering supervisory investment services were essentially retained in the Act. The jurisdictional grant in section 214 was not enlarged by amendment. Congress continued not to expressly provide for the bringing of any private damage action.

In 1960, Congress necessarily had the results of twenty years of conducting a census of the nation's investment advisers. It obviously did not see a compelling need for a private damage remedy. The protection of advisees from unscrupulous advisers is a purpose of the Act, but the protection

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10 As discussed in Point II, <u>infra</u>, Congress' treatment of this amendment shows that Congress intended a limited and sharply focused enforcement procedure.

11 The basic purpose of this amendment was to permit disclosure to state officials. See 1960 S. Rep. at 3510).

of advisees is not necessarily required to ensure the integrity of the securities market place. The abuses that might be directed against advisees may be peculiarly connected to the adviser-advisee relationship and not to a securities transaction. If the abuse is connected with a securities transaction, the private remedy afforded by Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5, promulgated thereunder, is available.

In 1970, the Investment Advisers Act was again amended, although immaterially. At the same time, however, the Investment Company Act was amended, significantly. The Investment Company Act amendments provided for an express right of action under the Investment Company Act by the addition of a subsection (b) to section 36. Therefore, at the time that Congress expressly provided for an additional private right of action under the Investment Company Act, it did not amend the Investment Advisers Act to expressly provide for a private right of action. The opportunity presented itself, and Congress declined to sieze it.

In conclusion, the regulation of investment advisers has historically involved a hesitant, cautious approach relative to other securities legislation; and Congress has withheld enforcement means granted in other securities legislation. A private right of action may not be fairly implied from the statutory scheme.

II

THE ENFORCEMENT SCHEME OF THE INVESTMENT ADVISERS ACT DOES NOT CONTEMPLATE A PRIVATE DAMAGE ACTION FOR A VIOLATION OF SECTION 206 AGAINST ACCOUNTANTS AND OTHER PERSONS WHO ARE NOT INVESTMENT ADVISERS

Section 206 of the Act prohibits certain transactions and conduct by an investment adviser directed against his client. By its express language, the section does not purport to regulate the conduct of a person other than an investment adviser.

The limitation of section 206 to an investment adviser is confirmed by reference to other sections of the Act. Sections 207 and 208 regulate the conduct of "any person" and not merely "any investment adviser". Congress, clearly, knew how to regulate the conduct of "any person" when it desired to do so.

Thus, a person other than an investment adviser cannot unilaterally violate section 206. An accountant then, for example, does not violate section 206 by unilaterally making a false accounting representation to a client of an investment adviser.[12] Similarly, the issuer

12 Section 202 (a) (1) excepts an accountant from investment adviser status when the performance of advisory services, as defined, by the accountant is solely incidental to the practice of his profession. The complaint in this case does not allege that Goodkin was an investment adviser (complaint § 20 at 9a). The plaintiffs' theory of the liability of Goodkin with respect to section 206 is aiding, abetting or participation in a conspiracy. In the lower court, Goodkin moved for summary judgment on the grounds, inter alia, that extensive discovery did not produce any indication of Goodkin's participation in violative collusive activity (see 26a 27a, memoranda in support of motion); the lower court did not reach these grounds.

of a security does not violate section 206 merely by making a false representation to a client of an investment adviser. Although their conduct may be prohibited by other statutes or regulations in appropriate circumstances such as Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, their conduct is not regulated by section 206.

The 1960 amendments to the Investment Advisers Act amended section 209, by amending subsection (e), to confer enforcement powers upon the Commission to enjoin any person who has aided and abetted any violation of the Act. The purpose of this amendment was to "make it clear that the Commission may obtain an injunction against any person who is aiding, abetting or inducing another person to violate the Act".[13]

At the same time, Congress also sought to make it clear that a private litigant could not bring a civil action against an alleged aider and abettor. Congress specifically drafted the 1960 amendments in a manner which restricted enforcement under the Act against aiders and abettors to injunctive actions brought by the Commission.

The original bill submitted in the 86th Congress was structured differently than the amendments which were enacted. The original bill contained a proposed new subsection (d) to section 208 which, in pertinent part stated, [I]t shall be unlawful for any person to aid, abet, counsel,

13 1960 S. Rep. at 3510.

command, induce or procure the violation of any provision of this title or any rule or regulation thereunder by any other person."[14] The proposed amendment to section 209(e) in the original bill made no reference to aiders and abettors.[15]

This approach of the original bill caused concern that the proposed amendments might be construed as authorizing a private civil action against aiders and abettors. Consequently, the original bill was modified with the agreement of the Commission to eliminate this possibility. The Senate Staff Memorandum on S.1182 states:[16]

> Section 11. Addition of prohibition against aiders and abettors
>
> Section 11 of S.1182 would add a new section to the Investment Advisers Act making it unlawful for persons to do indirectly, acts which they are forbidden to do directly. In addition, the section makes it unlawful for any person to aid, abet, or induce another person to violate the act. A similar provision, section 11 of S.1178, would add the same liability to the Securities Act of 1933. The aider and abettor addition is also requested in section 22 of S.1179 for the Exchange Act of 1934, which already has the "direct-indirect" prohibition.

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14 See Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, Eighty-Sixth Congress, First Session, on S.1178, S.1179, S.1180, S.1181, and S.1182 (hereinafter cited as 1960 Amendments Senate Hearings) at 496.

15 Ibid at 496, 497.

16 1960 Amendments Senate Hearings at 517-18.

The new section does not limit the application of the criminal aiding and abetting statute of the United States Judicial Code. Rather the amendment borrows the concept of aiding and abetting from the criminal law and seeks to insure that persons will be liable in civil administrative actions by the SEC, as well as in criminal actions.

It may be inquired if this provision should be limited under sections of the Advisers Act which treat the problem in part. As an instance, the power could be inserted in section 209(e), allowing the agency to seek an injunction against a person aiding and abetting a violator.

But the SEC insists that placing it under the injunction section, for example, would be unnecessarily restrictive. This power is sought in order to penalize abettors of all violations.

In addition, is it possible that private litigants, not only the SEC, may find in this section a vehicle by which to sue aiders and abettors? For the statute does not say who can sue--it merely says: "It shall be unlawful" (to aid or abet). The courts have extended from the SEC to private plaintiffs a right of suit under a comparably general antifraud provision of the 1934 Securities Exchange Act (sec. 10(b)).

A suggestion agreeable to SEC--Make it clear that no civil liability to private individuals is intended. The Investment Counsel Association of America does not object to this amendment.

The enacted 1960 amendments reflected the comments of the Senate Staff Committee.[17] The reference to aiders and abettors in the new subsection 208(d) was deleted; a reference

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17 In contrast, the similar proposed amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934 referred to in the text excerpted above were neither enacted as originally proposed nor enacted in accordance with the comments of the Senate Staff Committee. See Brennan v. Midwestern United Life Insurance Company, 259 F. Supp. 673, 677-80 (N.D. Ind. 1966).

to aiders and abettors in subsection 209(e) was inserted. Congress affirmatively made it clear that a private action cannot be brought against alleged aiders and abettors of a violation of the Act.

There are obviously sound reasons for Congress' rejection of a private right of action against aiders and abettors. Injunctive relief obtained by the SEC may be a "mild prophylactic",[18] while an award of damages, which may be in excess of the criminal sanctions contained in section 217 of the Act, may be ruinous. In an action brought for a violation of section 206, a complaint, as shown by the instant case, may involve an alleged breach of a private understanding between an alleged adviser and his client. The third party, the putative aider and abettor, would not normally be privy to such private understandings. Hence, the third party would not normally be apprised of any special disclosure needs of the advisee. Subjecting an outsider to the adviser-advisee relationship to the prospect of costly litigation for an investment adviser's failure to disclose matters which are material only as a result of a private understanding between others, is the kind of result which Congress likely sought to prevent when it specifically rejected a private right of action against alleged aiders and abettors.

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18 Securities and Exchange Commission v. Capital Gains Research, Inc., supra, at 193.

III

A PRIVATE DAMAGE ACTION MAY NOT BE BROUGHT UNLESS THE PLAINTIFF HAS SUFFERED ACTUAL DAMAGES AND THE DEFENDANT HAS RECEIVED PAYMENTS

The Act does not provide any guidance for the award of damages if there is a private action. Other securities legislation, however, provide measures or limitations which are directed toward excluding as damages an investor's loss which results from changes in the securities market place's valuation of a security. Section 11(e) of the Securities Act of 1933 provides that damages may not be obtained for price depreciation resulting from factors other than misleading statements in a registration statement. Section 28(a) of the Securities Exchange Act of 1934 limits damages to "actual damages". Section 16(b) of the Public Utility Holding Company Act of 1935 limits damages to "actual damages". Section 36(b) of the Investment Company Act of 1940 limits damages to "actual damages".

The dimensions of a private right of action under section 206, if there is such a right, are necessarily unclear in view of the relative novelty of the matter. It appears that certain types of claims brought against an investment adviser might be theoretically cognizable. In broad terms, these might include (a) a claim of fraud in connection with the purchase or sale of advisory services when the purchase or sale of such

services would involve the purchase or sale of a security (as the plaintiffs claim was the nature of their original investment in the limited partnership); (b) a claim of fraud in connection with the purchase or sale of advisory services which is unrelated to a securities transaction; and (c) a claim of fraud occurring in the course of the adviser-advisee relationship.

If a claim is brought for fraud in connection with a purchase or sale of advisory services which also involves the purchase or sale of a security, there does not appear to be any sound reason for awarding an amount greater than "actual damages". An award other than "actual damages" would circumvent the limitation imposed by Section 28(a) of the Securities Exchange Act on claims brought under Rule 10b-5, and there does not appear to be any reason for giving advisees broader rights than other investors.

If a claim is brought for fraud in connection with the purchase or sale of advisory services which is unrelated to a securities transaction, there also does not appear to be any sound reason for awarding damages other than "actual damages". This type of claim would clearly have little relationship to an interest in ensuring the integrity of the securities markets. This claim would be similar to any claim involving fraud in the contracting for services which would be remediable by rescission of the service contract.

The third broadly defined class of private claims with respect to section 206, a claim for fraud occurring in the course of the adviser-advisee relationship, presents greater difficulties for analysis in view of the broad spectrum of possible allegations.[19] Considering only the instant case, the plaintiffs seek restoration of the equivalent of their capital accounts as of September 30, 1968 for the failure of the alleged investment adviser in violation of a fiduciary duty to disclose the investment practice of investing in restricted securities.

Under traditional principles or restitution, a fiduciary may not retain and must disgorge property obtained or benefits derived in violation of his fiduciary duty. See Restatement of Restitution (1937) §§138, 150, 151. An analogous securities statute seems to embody these principles in its specification of a measure of damages for breach of fiduciary duty. Section 36(b)(3) of the Investment Company Act limits damages for breach of fiduciary duty to "actual damages" which "shall in no event exceed the amount of compensation or payments received".

Section 36(b)(3) of the Investment Company Act seems also to have been devised with another principle of restitution in mind. Under §138 of the Restatement of

19 We do not suggest that such a claim is necessarily cognizable. Blue Chip Stamps v. Manor Drug Stores, supra.

Restitution, a third party who has colluded with a fiduciary must have received a benefit in order to be required to make restitution. Similarly, section 36(b)(3) provides that no action under the section for breach of fiduciary duty may be brought against "any person other than the recipient of such compensation or payments".

When section 206 of the Act is applied to a situation resembling an investment company situation, such as a hedge fund like defendant Fleschner, Becker Associates, it should be construed in the light of section 36(b) of the Investment Company Act which is Congress' express treatment of a comparable situation. So construed, the plaintiffs-appellants in the circumstances of this case cannot bring a private action against Goodkin even if it were the case, which it is not, that Congress intended to authorize private actions against alleged aiders and abettors.

## CONCLUSION

For the foregoing reasons, the order and judgment of the District Court granting defendant's motion for summary judgment dismissing the complaint should be affirmed.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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ROBERT ABRAHAMSON and MAJORIE
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Plaintiffs-Appellants,

AFFIDAVIT OF SERVICE

-against-

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Defendants-Appellees.

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STATE OF NEW YORK )
: SS.:
COUNTY OF NEW YORK )

Patricia Breslin, being duly sworn, deposes and says: deponent is not a party to the action, is over 18 years of age and resides at 30-49 47th. Street, Astoria, New York 11103 on January 30, 1976 deponent served two copies of the within Supplemental Brief For Appellee upon :

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Securities & Exchange Commission

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in this action, at the address designated by said attorney(s) for that purpose by depositing a true copy of same enclosed in a post-paid properly addressed wrapper, in a official depository under the exclusive care and custody of the United States Postal Service within the State of New York.

Patricia Breslin

Patricia Breslin

Sworn to before me this 30th.

day of January, 1976.

Joyce D. Swanson

Notary Public

JOYCE D. SWANSON
COMMISSIONER OF DEEDS
City of New York 2-1139
Certificate filed in Kings County
Commission Expires April 1, 1977